Supreme Court, U. S.
FILED
SEP 8 1975
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-218

DEAN D. BEKKEN, *Petitioner,*

v.

MERRILL LYNCH PIERCE FENNER & SMITH, INC., *Respondent.*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF IN OPPOSITION

Of Respondent, Merrill Lynch Pierce Fenner & Smith, Inc.

ERNEST L. POTTER, JR.
Counsel for Respondent
Post Office Box 193
Huntsville, Alabama 35804
Telephone: 205/536-0096

Of Counsel:

N. LEE COOPER
CABANISS, JOHNSTON, GARDNER,
DUMAS & O'NEAL
First National-Southern Natural Building
Birmingham, Alabama 35203

PRESS OF BYRON S. ADAMS PRINTING, INC., WASHINGTON, D. C.

INDEX

	Page
Statement of the Case	1
A. The Proceedings in the District Court	2
B. The Relevant Facts	2
Argument	10
I. Bekken's Counterclaim Based on Violation of Rule 431	10
(A) The Distinction Between "Maintenance" Margin and "Initial" Margin	10
(B) Is There Authority for Petitioner's Counterclaim?	11
II. Bekken's Defense Based on Violation of Rule 431	17
(A) Is There Authority That Violation of Rule 431 Is a Defense to Merrill's Claim?	18
(B) The Meaning of Rule 431	20
(C) Does the Evidence Sustain the Lower Courts' Decisions?	22
Conclusion	25

AUTHORITIES CITED

CASES:

Avern Trust v. Clarke, 415 F.2d 1238 (7th Cir. 1969)	14
Bowman v. Hartig, 334 F.Supp. 1323 (S.D.N.Y. 1971)	14
Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir.), cert. den. 396 U.S. 838 (1969)	13
Colonial Realty Corp. v. Bache & Co., 358 F.2d 178 (2d Cir.), cert. den. 385 U.S. 817 (1966)	14
Goodbody & Company v. Penjaska, 8 Mich. App. 64, 153 N.W.2d 665, cert. den. 393 U.S. 16 (1968)	15, 18

Page

Gordon v. duPont Glore Forgan, Inc., 487 F.2d 1260, cert. den. 94 S.Ct. 3071 (1974) 15, 19, 24
Hirsch & Co. v. Pattiz, 19 App. Div. 2d 607, 241 N.Y.S. 2d 124 (1963) 14, 18
McCormick v. Esposito, 500 F.2d 620 (1974)....15, 16, 17, 18, 19, 20, 24
Naftalin & Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 469 F.2d 1166 (8th Cir. 1972) 22
Nichols & Co. v. Columbus Credit Corp., 204 Misc. 848, 126 N.Y.S.2d 715, aff'd. per curiam, 284 App. Div. 870, 134 N.Y.S.2d 590 (1953) 14, 15
O'Neill v. Maytag, 339 F.2d 764 (2d Cir. 1964) 14
Pearlstein v. Scudder & German, 429 F.2d 1136 (2d Cir. 1970), cert. den., 401 U.S. 1013 .....11, 13
Rubin v. Solomon, 136 Misc. 527, 241 N.Y.S. 495 (1930) 14
SEC v. First Securities Company of Chicago, 463 F.2d 981 (7th Cir.), cert. den. sub nom., McKy v. Hockfelder, 409 U.S. 880 (1972) 14
Shemtob v. Shearson, Hammill & Co., 448 F.2d 442 (2d Cir. 1971) 14
Simblest v. Maynard, 427 F.2d 1 (2d Cir. 1970) 23
Wells v. Blythe & Co.. Inc., 351 F. Supp. 999 (N.D. Cal. 1972) 14
Whyte v. New York Mercantile Exchange, 36 Misc. 2d 745, 233 N.Y.S.2d 37 (1962) 18

STATUTES AND REGULATIONS:

Securities Exchange Act of 1934, 15 U.S.C. § 78G...10, 11, 12, 13
12 C.F.R. § 220 et seq. 10, 11, 12, 21, 22
12 C.F.R. § 224 et seq. 12

RULES:

Rule 431, New York Stock Exchange.....10, 11, 13, 14, 15, 16, 17, 18, 19, 20, 21, 23, 24
Rule 8, Federal Rules of Civil Procedure 17
Rule 19, Supreme Court Rules 24

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

No. 75-218

DEAN D. BEKKEN, *Petitioner,*

v.

MERRILL LYNCH PIERCE FENNER & SMITH, INC., *Respondent.*

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

---

BRIEF IN OPPOSITION

Of Respondent, Merrill Lynch Pierce Fenner & Smith, Inc.

STATEMENT OF THE CASE

Because there has been no reported opinion of this case by the District Court or the Court of Appeals, and because a directed verdict was given at the conclusion of the trial by the District Judge, Honorable

Seybourn H. Lynne, respondent will present the facts (and argument) in greater detail than it otherwise would in order that this Court may fully understand the issues.

(A) The Proceedings in the District Court

Petitioner in his answer to respondent's complaint denied all the material allegations thereof except those relating to jurisdiction and that he had entered the agreement between the parties, respondent's exhibit 1 (A. 32, 213); the District Court in its pre-trial order stated "defendant pleads the general issue", and as to petitioner's counterclaim, stated: "The defendant contends that it has a cause of action under Rule 431 because he was misled by Mr. Yarbro, plaintiff's agent" (A. 8).

(B) The Relevant Facts

Respondent would add to or modify the petitioner's statement of the case by the following facts, which are taken from the testimony upon the trial of this cause.

Petitioner, Dean Bekken, on the day he opened his account with respondent, purchased 500 shares of Kaufman & Broad (K & B) stock, paying cash for them; it was four or five months later before he purchased on margin (A. 30 & 31). Bekken made the initial decision to purchase K & B, and did not seek Yarbro's advice and did not even know if Yarbro was familiar with K & B (A. 194 & 195; 30).

Bekken had first traded on the stock market in 1949 (A. 167). His net worth when he opened his Merrill account in July, 1971, and as shown on respondent's exhibit 2 was $150,000 (A. 30, 214 & 170). During the period from March through May, 1973, Bekken was

teaching school from 8:00 a.m. to 3:30 p.m., so that Yarbro could not call him, but could only leave messages for him (A. 99; 154 & 155; 164).

Bekken had lost money in the stock market before dealing with Merrill Lynch, and he knew that a broker could not predict a stock's performance (A. 168). Bekken had withdrawn funds from other margin accounts he had had prior to his Merrill Lynch account (A. 192 & 193).

When Bekken withdrew funds from his account in 1972, a total of $59,400, Yarbro informed him of the interest rate (A. 34 & 35), and that such action might later precipitate maintenance calls (A. 111). On March 16, 1973, at the time Bekken received his first maintenance call, his debit balance was $74,464. respondent's exhibit 4, A. 38, 216). At the time the account was liquidated (May 18) the debit balance was $41,191., so that if Bekken had not borrowed this sum, there would not have been any liquidation. (Respondent's exhibit 4, A. 38 & 218).

Bekken was aware during the March - May, 1973, period of the New York Stock Exchange (N.Y.S.E.) maintenance margin requirement (25%) and its relationship to Merrill Lynch's requirement (30%):

> Q. At what point in time did you become acquainted that there was a maintenance margin requirement of the New York Stock Exchange in the amount of twenty-five percent?
>
> A. I don't believe that I was aware of the New York maintenance requirement of twenty-five percent until the period of time of March to May of 1973, or I was aware that there was a maintenance margin requirement prior to that by some brokerage house, which one I don't remember, although

I had never received a maintenance margin requirement until March 16, 1973 (A. 150).

Q. Had Mr. Yarbro discussed it with you, the New York Stock Exchange maintenance margin requirements?

A. There was some mention of the fact that the New York Stock Exchange did have a maintenance margin requirement but that Merrill Lynch's was in excess of that and, therefore, that was what I would be confronted with and that was what the maintenance calls which I received were based on (A. 151).

Bekken stated he was not misled as to how his margin maintenance calls were determined (A. 210). Bekken was aware throughout the period of March - May, 1973, that Merrill Lynch could sell the securities in his account, and that he likewise could sell them (A. 171); that market appreciation would lessen the likelihood of maintenance calls, or could eliminate calls; and was aware of what his indebtedness was to Merrill Lynch (A. 172); and, also, that sales reduced his debit balance (A. 173).

Bekken was also aware that Yarbro could be overruled by his superiors and the account liquidated under appropriate circumstances:

Q. So, you were aware under certain circumstances which were not present until the latter part of this transaction, till this week in May when you were closed out, but that under certain circumstances you were aware that Mr. Yarbro's directions to you could be reviewed and overruled by someone above him with Merrill Lynch, were you not, if the circumstances changed what he told you could be overruled?

A. Yes.

Q. And you were aware of that throughout this period if the circumstances changed and the account became in what you previously termed a precarious position?

A. That's correct (A. 177 & 178).

Bekken knew, as Yarbro told him on several occasions (A. 52, 118), that continued market depreciation would require cash payments or a sale of securities to meet maintenance calls (A. 186). Bekken did not consider as "nominal" the approximately $34,000. he paid Merrill from March 20, 1973, to May 16, 1973, on his account as a result of maintenance calls, and he felt he had shown "good faith" in his efforts to meet the calls (A. 179 & 180). In Yarbro's discussions with Bekken about the maintenance calls Yarbro stated he always told Bekken the same as to what he must do to meet them (A. 99), and consistently referred to "eliminate", "satisfy" or "meet" the call (A. 47, 51, 55, 62, 66, 69, 94 & 95).

Bekken's action in response to the first maintenance call for March 16, received on March 20, 1973, a sale of 100 shares of Franklin Mint Corporation, fully met the March 16 call (A. 174 & 175; 116 & 117). During the critical period in May, as a result of sale of stock, deposits of cash and market appreciation, there was no maintenance call for May 3, 1973, under either Merrill Lynch or N.Y.S.E. requirements, nor any call under N.Y.S.E. requirements for May 9 (A. 75, 78; plaintiff's exhibits 4 & 6; A. 38 & 216; 74 & 219).

Yarbro told Bekken on May 11, 1973, that because the negative article on K & B in Barron's that the stock and warrants would probably open lower on May 14 (Monday), and that "a larger call would be coming" (A. 61

& 62). When the stock (and warrants) were closed to trading on May 14, Yarbro told Bekken the price under the circumstances would be lower on May 15, "which would increase the maintenance call" (A. 63). Bekken related Yarbro explained what he learned as to why K & B was closed on May 14, and ". . . then confirmed the fact that it probably would open appreciably lower on Tuesday . . ." (A. 158), and that a large maintenance call would be coming (A. 197). Because of the market close on K & B, Bekken's account could not be sold out on May 14 (A. 117).

Bekken admitted that Yarbro told him on May 15 that the maintenance call for the close that day would be "appreciably larger" (A. 162). Bekken told Yarbro he was going to try to sell some bank stock or borrow some money to meet the call (A. 67 & 68), and Yarbro related this to Edwards, his office manager (A. 137). The account was not in a debit equity until the close of the market on May 15 (A. 117 & 118; petitioner's exhibit 4; A. 38 & 218).

On either May 15 or May 16 Bekken's wife called K & B corporate offices to get information on the situation:

> Q. But sometime after May the 14th and prior to May 17th did someone in your family call the offices of Kaufman & Broad and talk with them?
>
> A. Yes.
>
> Q. Who was that?
>
> A. My wife.
>
> Q. Did she communicate to you what she learned?
>
> A. Yes, she did.
>
> Q. Were you encouraged by what you learned?
>
> A. Yes, I was.

> Q. And this in part affected your position and decision that you wanted to maintain in your account the stocks and warrants you held in Kaufman & Broad, did it not?
>
> A. Yes (A. 198 & 199).

On May 16 Edwards, the office manager of Merrill Lynch, in the absence of Yarbro, called Bekken's home in the morning, and since Bekken was out, told Mrs. Bekken to have Mr. Bekken call; that " . . . it was extremely urgent that he get in touch with me as soon as possible" (A. 126). Edwards was in the office all day, but Bekken did not call (A. 127). Bekken said he learned of Edwards' call at 5:00 or 5:15 p.m. (A. 163). Although he went to the Merrill Lynch office thereafter, he did not find out the amount of his maintenance call for that day until May 17 (A. 197 & 198).

Bekken testified that he probably could not have met the call for May 15 even if he had met in full with cash the call for May 14 (A. 189 & 190); and that if he had met the call each day during the period May 14-17, the next day there would have been a new call because of the declining value of his securities (A. 191; plaintiff's exhibit 4; A. 38, 216-218).

Bekken admitted Merrill Lynch had not misled him as to performance of K & B or any information supplied on K & B (A. 169). Until May 18, 1973, when the account was liquidated, Yarbro had never sold any securities of Bekken's without his knowledge and consent and by his direction (A. 59). On May 18, Bekken did meet a maintenance call on another account with Merrill Lynch and preserve it (A. 73, 129).

Bekken never inquired of Yarbro whether there was a specific time within which he must meet a mainte-

nance call (A. 47). As to Bekken's position on whether Merrill Lynch imposed a reasonable time limit, Bekken testified:

> A. Well, I contend during the week of 14 to 18 May that that was a reasonable time. I'm not quite sure that I fully understand your question.
>
> Q. I'm not certain I understand your answer. Do you feel that the requirement that Merrill Lynch imposed on you to meet the margin maintenance calls during the week of May the 14th to the 17th was an unreasonable or a reasonable period of time?
>
> A. Reasonable (A. 183).

Bekken's contention as to how he was misled by Yarbro and Merrill Lynch was stated thus:

> Q. In substance, Colonel Bekken, am I correct that your contention as to how you may have been misled by Mr. Yarbro as to meeting margin maintenance calls is that he didn't set a specific time within which you had to fully meet a maintenance call?
>
> A. Well, that with the fact that I had to fully meet it.
>
> Q. All right, sir.
>
> A. Not only the time, but the amount.
>
> Q. And is it not true that he did tell you that if the market continued to decline on your stocks there would come a point in time when given the fact that you didn't have a market appreciation, you would have to meet a margin maintenance call by payment of cash or sale of the securities?
>
> A. Well, he did mention that if the account got in such a state that Merrill Lynch would liquidate it (A. 184 & 185).

Yarbro's judgment was that he did not have discretion to excuse Bekken from meeting maintenance calls

(A. 84); however, Merrill Lynch did interpret Rule 431 as giving the broker some discretion as to the time within which a customer would be required to meet a call (A. 86, 104 & 105, 140). In exercising this discretion Merrill Lynch considered the following factors: the customer, his financial condition and knowledge of the market; the history of his account; the size of his account; the size of the maintenance call; the surrounding situation; and the customer's desires (A. 104-106; 122 & 123).

Bekken throughout expressed his desire not to sell his K & B securities. Yarbro expressed it thusly:

> A. He wanted to keep the Kaufman & Broad if at all possible because he was a believer in the stock, it had done well for him before, so he wanted to maintain the stock if at all possible and not sell it. . . . (A. 51).

On May 8 Bekken expressed again his desire to maintain K & B (A. 58); and on May 15, after Yarbro said Bekken reported his wife's call to K & B's corporate offices, Bekken said he "... didn't want to sell it unless he absolutely had to" (A. 66). On May 17 Bekken "... expressed a desire to want to hold the stock because he felt sure it would bounce back. . . ." (A. 69). He maintained this position to the end, telling Edwards on May 17:

> A. He did not want his stock sold out. In fact, he said if he could have some time he would like to retain Kaufman & Broad. He was very, very much sold on the idea that Kaufman & Broad was the stock to own (A. 128).

Bekken confirmed his desire throughout was to keep the K & B securities (A. 160, 186, 199).

ARGUMENT

I. BEKKEN'S COUNTERCLAIM BASED ON VIOLATION OF RULE 431

(A) The Distinction Between "Maintenance" Margin and "Initial" Margin

Section 7 of the Securities Exchange Act of 1934, 15 U.S.C. § 78g, grants to the Federal Reserve Board the power to control the amount of credit which can be initially extended for the purpose of purchasing new securities. Accordingly, the Board of Governors has issued Regulation T (Reg. T), 12 C.F.R. § 220, which controls the amount of "initial" margin credit that brokers may extend to customers. The time allowed for the deposit of Reg. T margin ("settlement") is five days for general or margin accounts, such as Bekken's, with seven days being required for payment of securities in special or cash accounts. 12 C.F.R. §§ 220.3(b)(1), 220.4(c)(2). Because of its importance in comparison, it should be noted that Reg. T specifically commands the broker to liquidate securities in a customer's account if required funds or securities are not forthcoming within the time allowed. 12 C.F.R. § 220.3(e), § 220.4(c)(2).

Reg. T does not require that the initial margin be maintained after initial compliance, 12 C.F.R. § 220.7 (b). The N.Y.S.E., however, prescribes the margin that must be maintained in its Rule 431. For the type of account involved in this case, Rule 431 requires that the aggregate of all securities "long" in the account must be maintained at a 25% margin level, which is to say that the equity in the account must equal 25% of the current market value of the securities. Exchange members, such as petitioner, may set their own "maintenance" margin requirement for their customers,

provided it is higher than the Exchange's, and petitioner's requirement in the spring of 1973 was 30%, which was the basis of the maintenance margin calls issued in the Bekken account.

The only reference to the amount of time which is allowed for payment of maintenance margin is contained in one sentence in Rule 431 which provides that: "The amount of margin . . . required . . . shall be obtained as promptly as possible and in any event within a reasonable time." N.Y.S.E. Rule 431(d)(6). It is significant to note that this language tracks that of the time required for payment of initial margin in such accounts under Reg. T, 12 C.F.R. § 220.3(b)(1), with the one important difference of "within a reasonable time" instead of "before the expiration of 5 full business days."

(B) Is There Authority for Petitioner's Counterclaim?

Petitioner's basic contention is that Rule 431 has the force and effect of law in that it must be integrated into the omission of Reg. T to regulate maintenance margin, because Congress declared in the Securities Exchange Act of 1934, as a matter of public policy, its concern for the regulation of credit in the purchase and ownership of securities. Thus, petitioner contends that Rule 431 places a duty upon the broker to obey the rule for the benefit of the customer, and a violation impliedly creates a cause of action in favor of the customer. Respondent submits there is no authority for this contention under the facts of the instant case.

The springboard for petitioner's contention is the holding in *Pearlstein* v. *Scudder & German,* 429 F.2d 1136 (2d Cir. 1970), *cert. den.,* 401 U.S. 1013. Here

the court implied a federal civil cause of action in favor of the customer against his broker for violation of 12 C.F.R. 220.4 (C)(2) for not liquidating the customer's securities within seven days for nonpayment of the required initial margin.

Apparently Congress has legislatively removed the primary basis for this decision, as also has the Federal Reserve Board. In October, 1970, Congress amended Section 7 of the Securities Exchange Act of 1934 by adding subsection (f), 15 U.S.C. § 78g (f)(1), which states in pertinent part:

> It is unlawful for any United States person, . . . to obtain, receive, or enjoy the beneficial use of a loan or other extension of credit from any lender . . . for the purpose of (A) purchasing or carrying United States securities, or (B) purchasing or carrying within the United States any other securities, if, under this section or rules and regulations prescribed thereunder, the loan or other credit transaction is prohibited . . . .

The Federal Reserve Board then conformed its regulations to this new public policy expressed by Congress by issuance of Regulation X, 12 C.F.R. § 224.2, which in pertinent part states:

> A borrower shall not obtain for any purpose credit from within the United States unless he does so in compliance with the following conditions: . . . (2) Credit obtained from a broker/dealer shall conform to the provisions of Part 200 (Regulation T) which is hereby incorporated in this part (Regulation X).

The term "obtain credit" is defined by 12 C.F.R. § 224.1, as meaning to "obtain, receive or enjoy the beneficial use of credit."

These changes make it clear, respondent submits, that the Securities Exchange Act of 1934 and Reg. T were not intended and do not now place a duty upon the broker for the benefit of the customer to obtain the payment of initial margin. For now that it is unlawful as to the customer also, it is clear that it is equally his duty to pay. Presumably this should remove any implied cause of action in favor of the customer for mere noncompliance by the broker of Reg. T. Certainly it should remove any basis for the assertion that there can be an implied cause of action for violation of Rule 431 by implied relationship to Reg. T. Respondent has found no cases following the *Pearlstein* rule since this change in the law.

This change in the Federal scheme of regulation of initial credit also makes it more manifest that the purpose of Rule 431 is protection of the broker, not the customer. It should be clear that a rule that requires a debtor to provide a continuing minimum amount of security to his creditor is intended for the benefit of the creditor, especially where the creditor's association imposes the rule. If the purpose were otherwise, then the rule could have very simply so stated.

There are only three cases that respondent has found that have determined the customer has an implied cause of action for the broker's failure to follow an exchange or association rule. However, none deal with Rule 431 and all involve allegations of willful misconduct on the broker's part tantamount to or actually constituting fraud. *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir.), *cert. den.* 396 U.S. 838 (1969) (N.Y.S.E. Rule 405, "know your customer"); *SEC* v. *First Securities Company of Chicago,*

463 F.2d 981 (7th Cir.), *cert. den. sub. nom., McKy* v. *Hockfelder,* 409 U.S. 880 (1972) (NASD "supervision of representatives" rule); *Avern Trust* v. *Clarke,* 415 F.2d 1238 (7th Cir. 1969) (NASD "suitability" rule). Respondent emphasizes that the petitioner in his counter-claim avers that Merrill Lynch *negligently* violated Rule 431 (A. 6 & 7); there is no claim, obviously because there is a complete lack of any facts to support any, that Merrill committed fraud, was guilty of any fraudulent misconduct or any willful misconduct tantamount to fraud.

The agreement between the parties in the instant case provides that: "This agreement and its enforcement shall be governed by the laws of the State of New York" (Respondent's exhibit 1, A. 32, 213). New York decisions have uniformly and consistently rejected claims for damages by customers for violations of exchange rules on margin requirements. *Rubin* v. *Solomon*, 136 Misc. 527, 241 N.Y.S. 495 (1930); *Nichols & Co.* v. *Columbus Credit Corp.,* 204 Misc. 848, 126 N.Y.S. 2d 715, *aff'd per curiam,* 284 App. Div. 870, 134 N.Y.S. 2d 590 (1953); *Hirsch & Co.* v. *Pattiz,* 19 App. Div. 2d 607, 241 N.Y.S. 2d 124 (1963).

The Federal courts have also declined to imply a cause of action for damages in behalf of the customer for mere violations of broker association or exchange rules. *Colonial Realty Corp.* v. *Bache & Co.,* 358 F.2d 178 (2d Cir.), *cert. den.* 385 U.S. 817 (1966); *O'Neill* v. *Maytag,* 339 F.2d 764 (2d Cir. 1964); *Shemtob* v. *Shearson, Hammill & Co.,* 448 F.2d 442 (2d Cir. 1971); *Bowman* v. *Hartig,* 334 F.Supp. 1323 (S.D.N.Y. 1971); *Wells* v. *Blythe & Co., Inc.,* 351 F.Supp. 999 (N.D. Cal. 1972).

Respondent's position that petitioner has no basis for counterclaim (or a defense) was adopted in a case closely in point by the Court of Appeals of Michigan, *Goodbody & Company* v. *Penjaska,* 8 Mich. App. 64, 153 N.W.2d 665, *cert. den.* 393 U.S. 16 (1968). The plaintiff-broker sued to recover a deficiency after liquidation, and the defendant offered as a defense and counterclaim that the plaintiff had not complied with an unspecified N.Y.S.E. rule (apparently 431). The account had been undermargined from February 3, 1960, to March 8, 1960, before demand for additional margin was made, and it was not sold out until March 29, 1960. The court cited with approval the holding of the N.Y. court in *Nichols & Co.* v. *Columbus Credit Corp., supra,* and held the defendant had no defense and no counterclaim, finding for the plaintiff for the amount of the deficiency.

This brings us to a consideration of the Fifth Circuit Court of Appeals' two recent decisions in *Gordon* v. *duPont Glore Forgan, Inc.,* 487 F.2d 1260, *cert. den.* 94 S.Ct. 3071 (1974) and *McCormick* v. *Esposito,* 500 F.2d 620 (1974). In *Gordon* the court held that a customer who knew that his account was undermargined and did not complaint could not recover damages from the broker on either a common law claim of breach of duty or an implied cause of action arising out of violation of N.Y.S.E. Rule 431. This despite the negligence or error of the broker in computing and notifying of the margin required, and an undermargining that occurred for several months continuously. Respondent submits this holding clearly establishes the petitioner has no basis for a counterclaim in this case, for there is no dispute in the testimony that throughout and on an almost daily basis Bekken received verbal

and written notices of his margin position—and that he never complained in any way about Merrill Lynch's conduct. (Of course Merrill Lynch also insists that it was not negligent, nor violated any rules of the N.Y. S.E., nor breached any duty owed Bekken, to be fully treated hereinafter.)

The holding in *McCormick* is even more closely in point. There it was held that the customer did not have a cause of action against the broker for a violation of Rule 431. The report shows that for the period November 18-28, 1969, the account was undermargined. The report is unclear as to whether Goodbody had knowledge of this, or not, since the only statement in that regard it:

> Goodbody's failure to discover the undermargining of McCormick's account *or to require that McCormick provide additional margin* might be considered less excusable than the oversight involved in the *Gordon* case. (500 F.2d at 627, emphasis added)

Nor does the report state what occurred on November 28, 1969, or shortly thereafter, although presumably the undermargining ceased because the account was not liquidated until February, 1970. However, the court placed emphasis on two factors: (1) there was no evidence that Goodbody intentionally ignored Rule 431 or sought to mislead McCormick; and (2) McCormick knew or had reason to know of the undermargining and did not complain.

Respondent contends the facts in the instant case sustain the district court's finding that under *McCormick* petitioner has no basis for a counterclaim. First, *assuming arguendo* that Merrill Lynch

did violate Rule 431, for the purposes of considering the ruling of *McCormick* in light of the instant facts, it must be remembered that petitioner in his counterclaim has characterized respondent's conduct as *negligent* (A. 6 & 7). This is insufficient to constitute a claim for relief. Second, there is no evidence that Merrill intentionally violated Rule 431 to mislead Bekken, which is the requirement of McCormick (500 F.2d at 628). Third, the evidence is overwhelming that Bekken was fully informed throughout and never complained of any action or inaction on the part of Merrill. Thus, it can be seen why the Fifth Circuit Court of Appeals affirmed the district court's verdict without opinion.

II. BEKKEN'S DEFENSE BASED ON VIOLATION OF RULE 431

Respondent would at the outset recall to the Court's attention that Bekken in his answer did not present any defense based upon violation of Rule 431. Certainly such defense must be considered as ". . . matter constituting an avoidance or affirmative defense", which pursuant to Rule 8, F.R.C.P., must be set forth affirmatively. As previously noted, the district court in its pre-trial order does not set out any other defense to respondent's claim than "the general issue" (A. 8). If it may be said that petitioner's counterclaim was mistakenly so designated or otherwise should be considered as a defense, respondent urges again to the Court that Bekken claims therein that Merrill *negligently* violated Rule 431; and the district court in its pre-trial order stated that this claim depended upon Bekken's contention that "he was misled by Mr. Yarbro" (A. 8). This last claim of misleading conduct was an effort by the petitioner, and a recognition

by the district court, that for Bekken to be able to state a claim under the holding in *McCormick* v. *Esposito, supra,* there must be conduct misleading to the customer by the broker. Obviously, therefore, the counterclaim was intended as just that, and not as a defense. There is no dispute, and no issue drawn by petitioner, that respondent proved all the material allegations of its complaint. Therefore, respondent submits that this reason alone is sufficient to sustain the courts' decision as to petitioner's claimed defense. However, respondent will go forward to show there is no merit to that defense.

(A) Is There Authority that Violation of Rule 431 Is a Defense to Merrill's Claim?

As mentioned before, the agreement between the parties provides that it is to be governed by New York law. The New York decisions have not allowed a violation of exchange rules requiring the broker to obtain maintenance margin to be a defense to the broker's claim for a debit balance after liquidation. *Hirsch & Co.* v. *Pattiz, supra; Whyte* v. *New York Mercantile Exchange,* 36 Misc.2d 745, 233 N.Y.S.2d 37 (1962).

The ruling of the court in *Goodbody & Company* v. *Penjaska, supra,* clearly holds that failure of the broker to obtain the maintenance margin required by the N.Y.S.E. (apparently Rule 431) for a period of almost two full months is no defense to the broker's action for a deficiency upon liquidation of the customer's account. There the court said:

> "Admittedly, they were in the office of plaintiff almost every day, and admittedly they were familiar with the market. At no time did they demand that their stock be sold. Certainly they had as great a duty to protect their account as did the plaintiff. They did not complain because the plaintiff was lenient. I doubt if complaint would have been made had the price of the stock advanced during the period of leniency" (153 N.W.2d at 667).

This statement fits perfectly the facts of the instant case.

The holding in *Gordon* v. *duPont Glore Forgan, Inc., supra,* does not provide an answer to this question. In *Gordon* the court did determine that the misconduct of the broker disallowed its recovery of a debit balance, but this decision obviously was not based upon violation of the N.Y.S.E. rule, but rather breach of the common law or contractual duty arising out of the broker-customer relationship. Judge Thornberry said:

> "While it is true that the Gordons had a contractual obligation to make up the $1550. deficit, it is also true that the deficit was at least partially the result of duPont's failure to compute the margin status correctly and give prompt notice of the undermargining. We cannot allow duPont to recover indebtedness that resulted from its own breach of duty, and therefore we must reject its counterclaim" (487 F.2d at 1262).

In the instant case the determinative facts or errors on the part of duPont in *Gordon* are not present, as Merrill Lynch did compute Bekken's margin status correctly and did give prompt notice of his undermargined condition.

McCormick is silent as to whether violation of Rule 431 may be a defense, since no claim was presented there by the broker against the customer. It would

appear, however, that under the rule of *McCormick,* namely an "intentional violation of Exchange rules misleading of its customer", such conduct by the broker would constitute a defense to a broker's claim for a deficit. However, that is not present in this case for: (1) as to petitioner's counterclaim, if it may serve as a defense, he claims "negligently"; (2) there is no proof Merrill "intentionally" violated Rule 431; and (3) petitioner was not misled. The evidence in these regards, as set out in the Statement of the Case, will be reviewed shortly hereinafter.

(B) The Meaning of Rule 431

Rule 431(b)(1) prescribes the amount of margin which must be maintained in a customer's account as 25%, and Rule 431(d)(6) provides: "The amount of margin . . . required by any provision of this Rule shall be obtained as promptly as possible and in any event within a reasonable time." There is no dispute that during portions of the period in question Bekken's account was undermargined. However, Merrill rejects the implication of Bekken's argument that in effect undermargining for *any* length of time constitutes a violation of the rule. The practical impossibilities of this argument when applied to the full scope of stock margin accounts in this country clearly demonstrates its fallacy. To petitioner "as promptly as possible" means literally that—and without exception or consideration of any circumstances; therefore, in every customer's account on margin, when for whatever reason the equity in the account fell below 25% of the market value, the broker would be required to sell securities at the first opportunity to restore the margin, provided the customer did not immediately provide the

requirement. Since the margin status is computed daily, this would mean at the opening of the market the following day. This would also mean there would be odd lot sales by the thousands, for numerous daily margin calls would occur for very nominal sums, which would not require a liquidation of the account to meet. Furthermore, petitioner's unrealistic interpretation of "as promptly as possible" would in the vast majority of cases mean that the customer might never even have notice of the call, for the broker would be required to act immediately upon learning of the undermargining. Surely this Court can see the havoc such an interpretation would wreak upon the stock brokerage business, and would by no means be in the best interest of the customer. Clearly the Fifth Circuit Court of Appeals recognized the fallacy of this claim of petitioner.

Petitioner in his argument for implied liability for breach of Rule 431 under his counterclaim seeks to read Rule 431 into Reg. T; however, in interpretation of Rule 431 he is unwilling to recognize the analogy between the two. The Reg. T requirement for deposit of initial margin is ". . . as promptly as possible and in any event before the expiration of 5 full business days. . . ." (12 C.F.R. § 220.3(b)(1)). Rule 431 employs the same language only substituting "within a reasonable time" for the 5 day limitation. Under petitioner's reasoning and argument the modifying phrase in Reg. T should be totally disregarded and the prescription of the regulation merely be "as promptly as possible". However, the regulation is uniformly interpreted as giving 5 days to meet the requirement.

The only judicial interpretation of time limitation requirements for deposit of margin that respondent

has found, and petitioner has cited none, is a case dealing with sale of securities in a special cash account as governed by Reg. T. In *Naftalin & Co.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 469 F.2d 1166 (8th Cir. 1972), a customer sold securities which he purported to own but in fact did not. In such situations Reg. T requires that ". . . the security is to be promptly deposited in the account" (12 C.F.R. § 220.4(c)(1)(ii)). The court rejected the holding of the district court that "promptly" was the equivalent of the seven-day period set forth in § 4(c)(2) (12 C.F.R. § 220.4(c)(2)) for special cash account purchase transactions. In its reasoning the court notes that there is no mandatory requirement for liquidation of sales transactions in such accounts if securities are not delivered within any specified period (just as there is no such provision under N.Y.S.E. rules if maintenance margin is not deposited). Thus, this decision finds that "promptly" may be a period longer than seven days and is a term allowing for flexibility.

Respondent contends that the prescription of Rule 431 that margin shall be obtained as promptly as possible and in any event within a reasonable time is a rule of flexibility; that it allows discretion to the broker to view the customer, his account, the market and all the surrounding circumstances to determine the time limitation to be imposed, which in the final analysis is to be "reasonable".

(C) Does the Evidence Sustain the Lower Courts' Decisions?

The test of the evidentiary requirement for granting a directed verdict has recently been stated as follows:

> "Simply stated, it is whether the evidence is such that, without weighing the credibility of the witnesses or otherwise considering the weight of the evidence, there can be but one conclusion as to the verdict that reasonable men could have reached."

Simblest v. *Maynard*, 427 F.2d 1, 4 (2d Cir. 1970).

Respondent will not undertake to review the evidence at length, relying largerly upon the facts previously stated in the Statement of the case. The pertinent considerations are whether there was any sufficient evidence for the jury to conclude that: (1) Merrill Lynch intentionally or negligently violated Rule 431; and (2) Merrill Lynch misled Bekken in any way.

Respondent submits that the facts do not show any violation of Rule 431 by Merrill. Was it unreasonable not to liquidate Bekken's account until he had been on call only 6 days under N.Y.S.E. requirements? Respondent's answer is no; not when you have a customer who has been trading on the market 24 years with seven other brokerage firms; who has net worth of approximately $150,000., and the amount of the margin call is only 10 to 15 percent of that; not when he has shown good faith in answering earlier calls, which were eliminated, and over the last two months he has reduced his indebtedness in excess of $33,000.; not when he is fully aware of all the circumstances of which Merrill was aware, and had investigated independently the unusual circumstances surrounding his principal security, and he still expressed the desire to keep these securities and that they not be sold. And especially not when Bekken himself stated he felt Merrill's requirement to meet the calls during the week of May 14-17 was reasonable (A. 183).

Under the testimony the only claim of any misleading conduct on the part of Merrill was the failure to explic-

itly tell Bekken of the existence of Rule 431 and its requirement that margin shall be obtained "as promptly as possible and in any event within a reasonable time". Merrill submits this was not misleading on its part; that the record is wholly-devoid of any evidence that this nondisclosure was intentional or negligent; that to the contrary the record is replete with evidence that Merrill in fact did convey in substance its understanding and interpretation of the rule to Bekken. Surely a broker is not required to explain all the rules governing his customer's account to the customer, especially when the customer does not ask. Where then is the evidence he was misled? There was none, as the lower courts correctly concluded.

Under the holdings in *Gordon* and *McCormick* respondent submits there was no evidence of any intentional violation of Rule 431 misleading to Bekken in view of all the facts. Certainly at the very least Bekken acquiesced in, and respondent submits the evidence clearly establishes he actively requested Merrill's forbearance to obtain the required margin for the brief periods that it did. And respondent submits that a contributing proximate cause of the relevant margin maintenance calls was the act of the petitioner himself in making the withdrawals he had made during the prior year, which constituted the vast majority of his indebtedness, which also must nullify his claimed defense.

CONCLUSION

Petitioner has not demonstrated any reason under Rule 19, Supreme Court Rules, why this Court should grant certiorari. There are no decisions of any other circuit court of appeals in conflict with the decision in the instant case. This case does not involve an important question of Federal law. This decision by the Fifth Circuit Court of Appeals is not in conflict with other decisions of that court. Under the law and facts the petitioner has not demonstrated any error by the Fifth Circuit Court of Appeals in its decision affirming the district court's directed verdict. Respondent submits that under the facts of the instant case there has been no error in the lower courts, and that a writ of certiorari should not issue.

Respectfully submitted,

/s/ Ernest L. Potter, Jr.
Ernest L. Potter, Jr.
Butler & Potter
P. O. Box 193
Huntsville, Alabama 35804
(Phone: 205-536-0096)

Of Counsel:

N. Lee Cooper
Cabaniss, Johnston, Gardner,
Dumas & O'Neal
First National-Southern Natural Building
Birmingham, Alabama 35203

Certificate of Service

I certify that copies of the foregoing Brief for Respondent have been served on opposing counsel by mailing copies by United States mail, postage prepaid, to Honorable Roscoe Roberts, P. O. Box 287, Huntsville, Alabama 35804.

This the 8th day of September, 1975.

Counsel for Respondent